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SUBJECT: Uncomfortable Squeeze for South China Shoe Factories

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¶1. (SBU) Summary: What do you do when it costs more to close a south China shoe factory than to continue operations? Some Hong Kong and Taiwan investors downsize and keep their production lines open, adopting a wait-and-see approach. Others turn the key on the door one evening and abscond at night, leaving unpaid workers and helpless landlords to clean up the mess. Increasing costs have led many investors to consider closing or moving their factories, with availability of capital, dependence on local supply chains, age (their own as well that of their equipment) and ownership succession as key factors in such decisions. What could trigger a move outside China? If there are signs of footwear supply chains moving out, a mass exodus might happen fairly rapidly. End summary.

High Costs to Quit, Not as High Costs to Continue
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¶2. (SBU) Closing a south China shoe is not cheap, according to Una Tang of Brilliant Footwear in Dongguan. The largest cost is severance pay for workers, which recently increased with passage of China's new Labor Contract Law in January 2008. Under the new regulations, each employee is eligible for one month's salary for each year worked in the factory, which Tang estimates would quickly add up to RMB 5,000,000 (USD 715,000) at her factories. In addition, Hong Kong and Taiwan investors -- who dominate many labor-intensive manufacturing industries in the area, including shoes -- would likely also incur substantial losses of real estate. Tang explained that because they are not citizens of the PRC, these investors are ineligible to hold land after they close the businesses for which the land was leased. Instead, Hong Kong owners like Tang face a stark choice -- they must liquidate the lease immediately or risk forfeiture if it sits idle without a registered "Chinese legal entity" to hold it. In Tang's case, she believes in the long-term potential of her businesses, and these regulatory factors helped her choose to keep her factories open but downsize their operations. She transferred one to her eldest son and continued managing another even though she was ready to retire, in hopes of eventually attracting another son into carrying on the family business.

¶3. (SBU) Tang's eldest son hesitated to take the reins two years ago, according to his mother. Despite well-established customers like Gap and Gymboree, first pick of all his mother's employees and equipment, and no capital costs except materials, William Tang of Ever Bright Footwear was not sure he wanted to live in Dongguan and work the long hours it would take to keep the business viable and growing. William said total costs for his small 500-person factory had risen approximately 20-30 per cent in the two years since he took over, and economic slowdowns in the United States and Europe have meant buyers are less willing to negotiate prices or place large orders. As a result, Ever Bright's production has been cut to approximately 180,000 pairs per month. He commented that small- and medium-scale manufactures have turned to in-house product design, increased automation and substitution of materials in order to lower costs while continuing to meet demand. In one room of his factory, 15 skilled employees operated computerized sewing machines, each with the daily output of eight people. This is part of a trend towards automation in a market where even monthly salaries as low as RMB 1200 (USD 170) make it difficult to compete for customers buying labor-intensive footwear and apparel products.

Some Owners Simply Run Away

¶4. (SBU) Reports of runaway factory owners have been widespread in the Pearl River Delta (PRD). Many describe owners shuttering facilities in the dead of night and leaving without paying workers. The situation hit home for Una Tang on the day we visited her factories. Government officials called her to report that an overseas investor who rented and independently operated another of her factories had fled without paying worker salaries or utilities for approximately two months. After heated discussion between officials and Tang's staff, she agreed to take responsibility for

the delinquent renter -- selling the land and factory and paying all overdue bills, including worker wages. When asked what would happen to the former renter, Tang indignantly said he would be impossible to find or prosecute, having already changed all of his phone numbers and contact information, and probably even his name.

Factory Owners Getting Older

¶5. (SBU) Many Hong Kong and Taiwan investors in the PRD have reached retirement age and are ready to reduce their role in day-to-day operations, but succession is often a problem as many adult children are uninterested in living or working near the factories their parents built and operated for the last 20 years or more. Tang pointed out that neither of her two younger sons seems willing to take control of one of her factories. Instead, Tang's long-time general manager continues to run the downsized facility with almost no profit. Meanwhile, she lives in Hong Kong and plans new strategies in a market fraught with constantly rising costs and tougher regulations.

Considering a Move, But Not Yet Moving

¶6. (SBU) Michael Yu, President of Pegasus Footwear in Panyu district of Guangzhou, said although he is exploring options for relocation or closure of his 18-year old shoe factory, he believes a wait-and-see approach is more prudent at this time. Yu's family shoe business has operated since 1956, but was relatively late in relocating from Taiwan to Guangzhou in 1990. Despite dramatically increased costs for PRD shoe factories and other labor-intensive industries in recent years, Yu said his factory currently employs 20,000 workers and produces shoes worth USD 150 million per year, and he is not convinced that it makes sense to relocate again to an area with even lower wages. Land and machinery at existing factories are completely paid off, and severance pay for workers would be costly, making the cost of continuing operations low compared with moving to inland areas of China or nearby southeast Asian countries like Vietnam, Thailand or Indonesia.

¶7. (SBU) In addition, Yu identified supply chains as the most critical factor in deciding where to locate a factory. According to Yu, the lack of a local supply chain in southeast Asian countries means the total cost of production is often higher than in China. Yu singled out Indonesia as the most dramatic example, saying the country's shoe industry has no supply chain and all materials must be imported from abroad. A stable political system, the size of the labor market and domestic consumer markets are also important factors for companies hoping to relocate outside China, according to Yu. Despite no immediate plans to leave, he is watching closely for signs of China's footwear supply chains moving out, predicting that such an exodus would quickly spell the end of his industry here. He described how each of the previous migrations of the shoe industry, from Japan to Taiwan and later from Taiwan to China, were preceded by massive disappearances of supply chain industries from the established markets. Yu warned that such a change would be so rapid as to catch many people by surprise, likely happening over a 12-24 month period.

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